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TR DAILY
Feb. 15, 2002

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TELECOM BUSINESS

QWEST SETS OFF ALARM BELLS
BY BORROWING \$4B FROM BANKS

All three corporate debt-rating agencies have rushed to downgrade Qwest Communications International, Inc., after the company found itself shut out of the usual markets for short-term funding. The downgrades prompted Frank J. Governali -- an equities analyst at Goldman, Sachs & Co. and once an enthusiastic booster of Qwest -- to warn clients that "avoiding the stock remains the best strategy."

Standard & Poor's led the round of downgrades yesterday (TRDaily, Feb. 14) and was quickly joined by Moody's Investors Service and Fitch Ratings. The agencies' actions left Qwest just two notches above a "junk" rating. But they said it was doubtful that Qwest would lose its "investment-grade" standing unless the company proved unable to resolve concerns over its short-term liquidity.

The agencies issued their downgrades after Qwest drew down its entire \$4 billion bank credit facility. The facility previously was untapped. But Qwest was forced to rely on the bank loans after it failed to find a market for its commercial paper -- the usual source of short-term, low-interest funding for investment-grade companies.

Like many companies, Qwest maintains a bank credit line as a "backstop" for its commercial paper program. But alarm bells go off in the financial markets when companies lose their access to the commercial paper markets and turn to their bankers.

Qwest said it would use the bank loans to retire its earlier commercial paper issues as they come due. It is considering converting the short-term bank loans into longer-term loans that would come due in 2003.

Joseph P. Nacchio, Qwest's chairman and chief executive officer, suggested the company was the victim of turmoil in the financial markets brought on by the Enron Corp. scandal. "Anyone can notice that what's going on in the market today is a series of rumors, innuendos, and old news being presented as new news," he said late yesterday during a conference call with investors.

"In this very nervous post-Enron market, we believe that drawing down our bank facility is the most efficient and least-cost way to address this liquidity issue," he said. The move will not add to Qwest's net debt, he said, or affect Qwest's previously announced plans to reduce long-term debt through the sale of equity-linked securities and assets (TRDaily, Feb. 5 and Jan. 29).

But Mr. Nacchio announced that Qwest would cut expenses further by reducing its 2002 capital expenditures budget to \$3.7 billion. Its capex budget was set at \$4 billion.

Mr. Nacchio said he would immediately begin holding regular weekly conference calls with investors to answer questions and address rumors. "I hope we get to the point where no one shows up for these calls and things are back to normal," he said. "But we're not going to let rumors and innuendo drive the value of our company."

Questions have arisen recently about the way Qwest has accounted for sales of long-term bandwidth contracts known as indefeasible rights of use; a transaction with KMC Telecom involving the sale of equipment and purchase of services; and its relationship with Global Crossing Ltd. The company received a subpoena this week from the Securities and Exchange Commission for documents related to Global Crossing.

"Many questions can't be answered," Mr. Governali said in a report issued today. "Given these concerns . . . avoiding the stock remains the best strategy." -- Tom Leithauser, tleithauser@tr.com



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BellSouth Reports Fourth Quarter Earnings

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- Data revenues grow 25 percent, exceed \$1 billion every quarter
- DSL customers reach 620,500, increase 189% for year
- Broadband coverage reaches 70% of households

For Immediate Release:

January 22, 2002

Atlanta, Georgia - Driven by growth in data and broadband services, BellSouth Corporation (NYSE: BLS) reported normalized earnings per share (EPS) of 63 cents in the fourth quarter of 2001, before special items and foreign currency effects. Normalized EPS in the fourth quarter of 2000 was 59 cents, before foreign currency impacts of minus 2 cents.

On a reported basis, EPS in the fourth quarter of 2001 was 42 cents, reflecting charges of 12 cents for previously announced restructuring actions and 9 cents for the further impairment of an equity investment in Qwest Communications International. In addition, reported results included foreign currency effects that reduced EPS by 1 cent.

For the year, normalized EPS was \$2.34 in 2001, compared to \$2.24 in 2000. Reported EPS was \$1.36 in the latest year, compared to \$2.23 in 2000. The foreign exchange impact in 2001 totaled 12 cents per share, compared to 4 cents per share in the previous year. Including Cingular Wireless, revenues were a record \$29.6 billion in 2001, up 7.8 percent for the year. Normalized net income was \$4.42 billion in 2001, compared to \$4.24 billion a year earlier. Reported net income in 2001 was \$2.57 billion, compared to \$4.22 billion in the previous year.

Data and Broadband

Data revenues were \$1.2 billion in the three months ended December 31, 2001, capping a year in which BellSouth's data revenues grew rapidly and exceeded \$1 billion each quarter. Data revenues increased at an annual rate of 24.9 percent in the final quarter of 2001, and represented 15.8 percent of the company's total revenues. For the full year, data revenues were \$4.5 billion.

BellSouth finished 2001 with 620,500 retail and wholesale

customers for its DSL high-speed Internet access service, posting an annual growth rate of 189 percent. For the year, BellSouth had DSL revenues of \$254 million, a nearly four-fold increase compared to \$52 million in 2000. The company also announced January 3 that broadband is now available to almost 70 percent of the households BellSouth serves.

In addition to broadband's gains in the consumer and small business marketplaces, BellSouth's data revenue growth continues to be fueled by high-speed, high-capacity services for medium and large businesses, as well as wholesale customers. These services include new optical networking products such as Gigabit Ethernet, and the addition of data storage capabilities, known as Storage-Enabled Network, to BellSouth's comprehensive e-platform. Both were introduced during the fourth quarter.

Domestic Wireless / Cingular

BellSouth's domestic wireless revenues in the fourth quarter of 2001 were \$1.5 billion, representing the company's 40 percent share of Cingular Wireless, the second largest wireless company in the U.S. This is a gain of 18.8 percent compared to the same quarter a year ago, when Cingular was formed. In the fourth quarter, Cingular added 325,000 customers, and ended the year with 21.6 million, an annual growth rate of 9.7 percent. Cingular continues to focus on profitable growth, and leads the wireless industry in operating income. BellSouth's share of Cingular operating income was \$221 million in the fourth quarter of 2001, 46.4 percent higher than the same three months a year ago. During the fourth quarter, Cingular announced a major technology transformation investment, beginning with a network overlay that puts its customers on a clear path to the wireless data and voice services of the future, known as 3G, for Third Generation. Cingular also forged an innovative infrastructure joint venture with VoiceStream that will allow Cingular to compete in New York City much more quickly and cost-effectively than building its own network from scratch.

Latin America Group

Consolidated Latin America revenues, including advertising and publishing, were \$683 million in the fourth quarter. Earnings before interest, taxes, depreciation and amortization, or EBITDA, increased 57.7 percent in the fourth quarter, to \$265 million, and was up 35.1 percent for the year. EBITDA margin improved by 17.4 percentage points, to 38.5 percent, compared to the fourth quarter of 2000. On a proportionate basis, BellSouth had 7.4 million customers in Latin America at the end of the year, an annual growth rate of 10.9 percent. BellSouth and its wireless partners cover a total population of 224 million in 11 Central and South American countries.

Additional Quarterly Highlights

Adjusted to include BellSouth's 40 percent share of Cingular, total revenues of \$7.6 billion increased 4.5 percent compared to the fourth quarter of 2000. Normalized net income in the fourth quarter of the latest year was \$1.19 billion, a gain of 6.6 percent compared to \$1.12 billion in the same quarter of 2000. Fourth quarter reported net income was \$792 million in 2001 and \$1.12 billion in 2000.

2002 Guidance

BellSouth's guidance for certain key financial and business metrics in 2002 remains as follows:

Normalized earnings per share 7% to 9% growth*
Total operating revenue (including Cingular) 5% to 7% growth
Data revenue 22% to 25% growth
Capital expenditures (excluding Cingular) \$5.3 to \$5.5 billion
DSL high-speed Internet customers 1.1 million at 12/31/02

*Includes effect of required accounting change under FAS 141 and 142. Excludes foreign currency gains or losses.

About BellSouth Corporation

BellSouth Corporation is a Fortune 100 communications services company headquartered in Atlanta, GA, serving more than 45 million customers in the United States and 15 other countries.

Consistently recognized for customer satisfaction, BellSouth provides a full array of broadband data and e-commerce solutions to business customers, including Web hosting and other Internet services. In the residential market, BellSouth offers DSL high-speed Internet access, advanced voice features and other services. BellSouth also provides online and directory advertising services, including BellSouth® Real PagesSM.com.

BellSouth owns 40 percent of Cingular Wireless, the nation's second largest wireless company, which provides innovative wireless data and voice services.

In addition to historical information, this document contains forward-looking statements regarding events and financial trends. Factors that could affect future results and could cause actual results to differ materially from those expressed or implied in the forward-looking statements include: (i) a change in economic conditions in domestic or international markets where we operate or have material investments which would affect demand for our services; (ii) the intensity of competitive activity and its resulting impact on pricing strategies and new product offerings; (iii) higher than anticipated cash requirements for investments, new business initiatives and acquisitions and (iv) those factors contained in the Company's periodic reports filed with the SEC. The forward-looking information in this document is given as of this date only, and BellSouth assumes no duty to update this information.

If viewing this press release on the Internet, you may access the below listed information by selecting the applicable hyperlink.

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For More Information:

Jeff Battcher (404) 713-0274
Mary Beth Conklin (404) 249-3167
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BellSouth Corporation Headquarters

1155 Peachtree St. NE
Atlanta, GA 30309-3610

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BellSouth Updates 2002 Financial Guidance

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For Immediate Release:

February 21, 2002

ATLANTA - BellSouth Corporation (NYSE: BLS) announced today that it is updating financial guidance for 2002 due primarily to recent currency devaluations and deteriorating economic conditions in Argentina and Venezuela. The company indicated that both revenues and earnings are being affected by these factors. Reported earnings for the first quarter of 2002 will also include a non-cash charge of \$200 million to \$230 million related to remeasurement of U.S. dollar denominated liabilities, primarily long term debt. The company further stated that the financial impact of delayed entry into the long distance market, while not material to guidance as a stand-alone event, was a contributing factor in the revisions.

BellSouth also reduced its forecast of capital expenditures by \$500 million, to a range of \$4.8 billion to \$5.0 billion, citing continued weakness in demand, primarily in the domestic telecom market.

BellSouth's guidance for key financial and business metrics for 2002 follows:

Total operating revenue growth (including Cingular)	2% to 4% growth
Normalized earnings per share growth (excluding FX)	3% to 5%*
Capital expenditures (excluding Cingular)	\$4.8 to \$5.0 billion
Data revenue	22% to 25% growth
DSL high-speed Internet customers	1.1 million at 12/31/02

*Includes effect of required accounting change under FAS 141 and 142. Excludes foreign currency gains or losses.

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For more information contact:

Jeff Battcher, BellSouth
jeff.battcher@bellsouth.com
(404) 713-0274

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BellSouth Corporation Headquarters

1155 Peachtree St. NE
Atlanta, GA 30309-3610

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CABLE INDUSTRY COMMENT

May 7, 2001	CABLE AND BROADBAND SERVICES	
Douglas S. Shapiro		Industry Overview
Michael L. Savner		DJIA: 10951
Jeffrey R. Toohig		S&P 500: 1267

Reassessing the Profitability of High-Speed Data

- ◆ While investors are generally optimistic about the potential of cable's high-speed data business, several data points over the past few weeks and months suggest that the business may end up being even more profitable than thought.
- ◆ With most of the 1Q numbers in, contrary to expectations, the deployment rate of cable high-speed data subscribers in 1Q wasn't apparently impacted by either seasonality or a weaker macroeconomic environment....
- ◆ ...DSL seems less likely to catch up anytime soon...
- ◆ ...And long-term pricing pressures aren't materializing. (And even small changes in pricing assumptions can have big impacts on profitability.)
- ◆ For sake of conservatism our models continue to assume that in 2001 the rate of high-speed data additions slow from the 4Q00 pace; that DSL eventually overtakes cable for residential high-speed connections; and that pricing pressure pushes ARPUs lower over the next five years — but these assumptions are beginning to look *too* conservative, suggesting the business may be substantially more profitable than our models indicate.

There's little debate that high-speed data is a significant opportunity for the cable industry. There is clearly substantial pent up demand; because cable has a relatively elegant solution, it should continue to maintain significant market share; and it's profitable. But because it is primarily a fixed-cost business (unlike the core cable business, for which programming is the largest cost and is variable), relatively small changes in assumptions about the business model can have a large impact on its profitability. **We believe there have been a series of data points lately that suggest some of the prevailing assumptions about the model are too conservative.** Specifically:

- ◆ **Deployments aren't showing either seasonality or the impact of macroeconomic softness in 1Q.** While most observers expected that demand would slacken in the first quarter owing to both seasonality and macroeconomic softness, almost all of the cable operators which have reported 1Q results so far have continued to show accelerating rates of deployment.
- ◆ **DSL isn't catching up.** There has generally been an expectation that, while cable had a good head start over DSL, DSL providers would eventually get more aggressive and ultimately rival, and then

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pass, cable's rate of deployment. But with the deterioration of the data CLECs and apparently less motivation for the ILECs to spur deployment, cable continues to maintain or increase its lead.

- ◆ **Pricing pressure isn't materializing; in fact, there may be pricing power.** It has also been widely expected that both cable and DSL providers will successively reduce prices in an effort to steal share and accelerate penetration. But not only has this price pressure failed to materialize, but many DSL providers are actually raising prices and some cable operators are looking to follow suit. As we show below, the impact on profitability of just *maintaining* ARPU steady can be dramatic.

Our models (similar, we believe, to most models on the Street) have assumed that the rate of high-speed data additions moderate from the 4Q00 pace in 2001; that DSL eventually overtakes cable for residential high-speed connections; and that pricing pressure pushes ARPUs lower over the next five years. And while for the sake of conservatism we aren't changing any of these assumptions yet, all are beginning to look *too* conservative.

Figure 1

SO FAR, THE PACE OF 1Q01 CABLE MODEM INSTALLS HAS OUTPACED 4Q00

	1Q01	4Q00	1Q00
AOL Time Warner			
<u>High Speed Data</u>			
Net Adds	237,000	227,000	117,000
Per Week	18,231	17,462	9,000
% of Footprint Marketed	67%	63%	43%
AT&T Broadband			
<u>High Speed Data</u>			
Net Adds	206,000	239,000	132,000
Per Week	15,846	18,385	10,154
% of Footprint Marketed	68%	63%	44%
Cox			
<u>High Speed Data</u>			
Net Adds	105,223	83,131	55,979
Per Week	8,094	6,395	4,306
% of Footprint Marketed	77%	73%	52%
Charter			
<u>High Speed Data</u>			
Net Adds	90,900	87,800	37,300
Per Week	6,992	6,754	2,869
% of Footprint Marketed	55%	50%	47%

Source: Company reports.

Deployment Rates Haven't Suffered From Seasonality or Macro Weakness

As shown in Figure 1, with the exception of AT&T Broadband, which only showed a moderate sequential decline in the rate of additions in 1Q, contrary to expectations the pace of high-speed data additions for cable wasn't apparently impacted by either seasonality or macroeconomic weakness. The root of the former concern is that the cable industry's increasing reliance on retail distribution would cause deployment of modems to exhibit the seasonality typical of other consumer electronics items and also that cable modem demand is probably closely tied to purchases of new PCs (which are also heavily weighted to the fourth quarter). And, obviously, the root of the latter concern is that, with the stock

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market decline and a barrage of press coverage about the slowing economy, consumers would be less likely to sign on for higher-cost services. But neither fear has come to fruition. How come? We think there are two reasons:

- ◆ **Besides strong demand, larger footprints, retail availability and self-install are all offsetting seasonality.** As shown in Figure 1, cable operators continue to steadily increase the proportion of their footprints to which they are marketing the service, helping offset seasonality. In addition, while Cablevision's ownership of The Wiz enabled it to push aggressively into retail over a year ago, the rest of the industry has only recently begun to establish significant retail distribution. In October Excite@Home (along with cable partners AT&T, Comcast and Cox) and RadioShack announced a strategic alliance by which RadioShack will sell Excite@Home's self-installation kit and plug-and-play modems, securing the first nationwide retail distribution for cable high speed access. As another example, after targeting 250 retail outlets by the end of 2000, Comcast finished the year with 600 and forecasts it will have 1,200 by yearend 2001. Cox, Charter and AT&T Broadband have all also begun more concerted efforts to increase retail availability. In addition, self-install is starting to become a meaningful source of new additions across the industry. In 4Q Comcast attributed one-third of its additions to self-install, finding that 75% didn't require a truck roll. Similarly, in 1Q Cox indicated 30% of new high-speed subscribers were acquired through some form of self-install (either full self-install or "assisted" self-install), also finding that only 10% required service calls to complete installation. And after showing some reluctance to pursue self-install, Charter announced in its 1Q conference call last week that it is also testing it in Michigan, similarly experiencing a 90% success rate.
- ◆ **We don't think it's obvious the rate of deployment suffers significantly in a downturn.** While it's conventional wisdom that consumers will be less likely to take higher-priced services in a downturn, we don't think it's obvious the rate of high-speed data deployment suffers dramatically. There are three reasons: 1) Internet access in many households is considered as crucial as phone or TV; 2) as cable operators frequently point out, if dial-up subscribers are paying for a second phone line dedicated to data, a cable modem service at \$40 monthly is actually on par with the cost of most dial-up ISPs and another \$15-20 for a second line; and 3) perhaps most importantly, because high-speed data deployments continue to be largely supply constrained (i.e., constrained by lack of availability and the number of installers deployed), not demand constrained, even if demand diminishes at the margin, it may not actually reduce the pace of deployment.

DSL Doesn't Seem Likely to Catch Up Anytime Soon

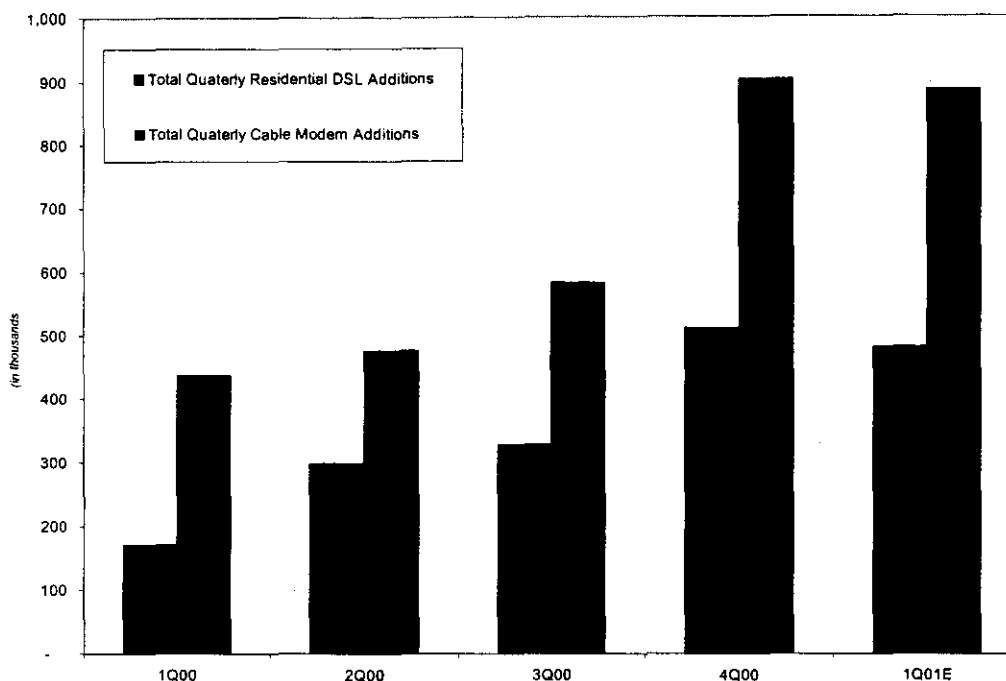
We continue to believe that the residential high-speed access market will easily be large enough to support both cable and DSL. For more detail, see *Broadband Brief — Cable, DSL, and the Big Picture*, dated March 27, 2000, for a discussion about why we believe that the network effects of abundant bandwidth will result in a proliferation of bandwidth-intensive applications that will make narrowband obsolete. In another piece (see *Broadband Brief — The Broadband Killer Napp*, dated November 28, 2000) we look specifically at the impact of peer-to-peer applications on broadband demand (including the surprising results of our survey that over 70% of Napster users are on broadband connections). Nevertheless, the consensus expectation is that DSL will eventually pass cable for residential connections. The rationale is very reasonable: the ILECs have substantially larger marketing budgets; substantially more installers, CSRs and technicians; and most PCs are right next to a phone jack, likely ultimately making self-install of DSL much more feasible. However, the likelihood of this occurring anytime soon seems diminished lately:

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- ◆ **The DLECs and resellers have all but disappeared as a factor in residential broadband.** A year ago many providers were marketing DSL: ILECs, data CLECs (DLECs), and a potentially unlimited number of DSL resellers. Today, the last two have all but disappeared. Many of the second-tier DLECs and resellers have closed their doors, including Comdisco (Prism), Fastpoint, Flashcom, HarvardNet, Relaypoint, Vectris and Zyan, among others. And the three nationwide DLECs seem headed in the same direction. Northpoint is, of course, already bankrupt (and, notably, when AT&T recently purchased its assets for \$0.10 on the dollar, it refused to service the subscribers in the network, claiming it was too difficult and expensive to do so). Rhythms has announced intentions to formally put the business up for sale and never made a substantive push into residential anyway. And recently a coalition of Covad's bondholders requested that the company close up shop and return whatever cash it has left to its creditors. The ILECs are now the only real force behind DSL.
- ◆ **The ILECs don't seem as eager as they once did to pick up the pace.** The ILECs generally added DSL subscribers at a much faster pace in 4Q00 than in 3Q00. And it is often written that DSL deployments are growing at a faster rate than cable modem deployments. However, this statement is deceptive because DSL is growing off a smaller base. As shown in Figure 2, **cable continued to outpace residential DSL deployments in the second half of last year, and by a greater margin than in the first half.** In 2Q00, cable added 60% more high-speed subscribers than DSL, while in both 3Q and 4Q it added close to 80% more. Moreover, despite promises by ILECs to pick up the pace, it doesn't seem to be happening. As also shown in Figure 2, even assuming that the large cable operators, which haven't yet reported (namely Adelphia, Cablevision and Comcast) all show a sequential decline in new sub additions in 1Q, with most of the large cable operators' and all of the ILECs' numbers in, **it looks like cable net additions will be about flat-to-down 2% sequentially while DSL deployments are down 10% sequentially in 1Q01.** SBC, arguably the most aggressive RBOC, has recently been ratcheting down guidance and just raised the price point for consumer DSL to \$49.95 from \$39.95, instituted higher install fees, and reduced the number of installers dedicated to DSL. Verizon and BellSouth late last week indicated that they are also raising rates in certain markets, with Verizon also saying it will no longer offer discounts on installation. To us, these actions suggest the ILECs aren't as eager to spur deployment as they once were.

Figure 2

CABLE MODEM ADDITIONS CONTINUE TO OUTPACE DSL ADDITIONS BY A WIDE MARGIN



Source: Banc of America Securities LLC estimates and company reports.

We think there are two chief reasons why they aren't being as aggressive: 1) **They can't afford to sacrifice EPS growth, particularly under current market conditions.** Both SBC and BellSouth have recently reduced earnings guidance, largely reflecting the costs of the DSL deployment. The moves not only put pressure on the stocks when announced but have caused investors to start to question the conventional wisdom that RBOC stocks are defensive. 2) In addition, **the ILECs are arguably more secure in their local franchise monopolies today than they have been in a decade.** That's because the presumed threats to their local businesses have eroded rapidly over the past several months — long distance providers are struggling with a deteriorating business and the CLECs are going through a painful shake-out that may leave few standing. There is a re-monopolization of the local phone business underway. As a result, we think the ILECs may feel less pressure to aggressively pursue any costly new revenue streams, including DSL.

Long-Term Pricing Pressure May Turn Out to Be Pricing Power

Nearly every model of the economics for high-speed data assumes that ARPUs decline over the next five years. This, too, seems a reasonable assumption. As both DSL providers and cable operators move toward 100% availability of high speed and subscriber growth begins to slow, it's logical that the business will get more competitive and ARPUs will decline. Our models, for instance, generally assume that cable high-speed data pricing declines from roughly \$40 today to the high \$20's over the next five-seven years.

Banc of America Securities

However, this assumption also increasingly seems questionable. As noted above, demand continues to apparently remain strong at current prices. And, as also mentioned above, BellSouth, SBC and Verizon have all announced price increases (or at least intentions to increase prices). In addition, AOL Time Warner has recently discussed pushing through increases on its flagship AOL service (thereby raising the floor for broadband pricing) and for the past year has asserted that it believes it also has pricing flexibility on its high-speed cable service. Last week AT&T notified franchising authorities and published legal notices in newspapers alerting consumers that it will raise prices for most of its high-speed customers by \$6 monthly starting in June. Charter also stated on its conference call last week that it has experimented with price increases in some markets and several other cable operators have admitted they are looking at the opportunity to raise prices. We're not sure this is a good idea. We'd rather see cable operators take advantage of the DSL pricing umbrella to take more share and there is a risk price increases could yield a political backlash.

But whether they push through increases or not, because it is a generally fixed-cost business, even keeping ARPUs constant makes a big difference relative to our (and consensus) assumptions that ARPUs decline. In Figure 3 we show the IRR and NPV of a high-speed data subscriber under different scenarios. For simplicity, we leave subscriber acquisition cost, churn and operating expenses fixed for all three scenarios, only varying prices. **As illustrated, we calculate that, all else being equal, just leaving prices constant substantially boosts IRR substantially (to almost 50% from 36%) and almost doubles the NPV of a high-speed data subscriber.** Assuming that ARPUs increase obviously has an even more dramatic effect.

Figure 3

EVEN MODEST CHANGES IN RETAIL PRICING HAVE DRAMATIC EFFECTS ON IRR

Assumptions:								
SAC								\$350
Headend Costs/Provisioning Cost Per Sub								\$50
Churn								1.25%
Implied Life Per Sub (Years)								6.7
Prices Decrease								
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	
Price	\$40.00	\$37.00	\$35.00	\$33.00	\$31.00	\$30.00	\$28.00	
% Price Change		-8%	-5%	-6%	-6%	-3%	-7%	
Operating Expense	\$24.00	\$22.57	\$22.40	\$20.79	\$19.22	\$18.30	\$17.08	
Recurring EBITDA Margin	40%	39%	36%	37%	38%	39%	39%	
Recurring EBITDA	\$16.00	\$14.43	\$12.60	\$12.21	\$11.78	\$11.70	\$10.92	
IRR	36%							
NPV	\$312							
Prices Unchanged								
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	
Price	\$40.00	\$40.00	\$40.00	\$40.00	\$40.00	\$40.00	\$40.00	
% Price Change		0%	0%	0%	0%	0%	0%	
Operating Expense	\$24.00	\$22.57	\$22.40	\$20.79	\$19.22	\$18.30	\$17.08	
Recurring EBITDA Margin	40%	40%	40%	40%	40%	40%	40%	
Recurring EBITDA	\$16.00	\$17.43	\$17.60	\$19.21	\$20.78	\$21.70	\$22.92	
IRR	49%							
NPV	\$599							
Prices Increase								
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	
Price	\$40.00	\$45.00	\$47.25	\$49.61	\$50.00	\$50.00	\$50.00	
% Price Change		13%	5%	5%	1%	0%	0%	
Operating Expense	\$24.00	\$22.57	\$22.40	\$20.79	\$19.22	\$18.30	\$17.08	
Recurring EBITDA Margin	40%	50%	53%	58%	62%	63%	66%	
Recurring EBITDA	\$16.00	\$22.43	\$24.85	\$28.82	\$30.78	\$31.70	\$32.92	
IRR	63%							
NPV	\$942							

Source: Banc of America Securities LLC estimates.

Banc of America Securities

This Whole Internet Thing Could Be Big

Investors are generally sanguine about the potential of high-speed data to boost the rate of cable operators' EBITDA growth, increase retention, perhaps draw some subscribers back from DBS and, because of its relatively low incremental capital cost, boost returns on capital. However, recent data points lead us to believe that it may be an even better business than expected. As shown above, the economic impact of even maintaining ARPUs, rather than seeing them decline, is substantial. **But even this analysis underestimates profitability: it fails to take account of the potential that slackening efforts by DSL providers will enable cable to ultimately take more share than most expect and it fails to take account of the ability to boost both penetration and ARPUs by moving to tiered pricing.** For sake of conservatism our models continue to assume that in 2001 the rate of high-speed data additions slow from the 4Q00 pace; that DSL eventually overtakes cable for residential high-speed connections; and that pricing pressure pushes ARPUs lower over the next five years — but these assumptions are beginning to look *too* conservative, suggesting the business may be substantially more profitable than our models indicate.

Banc of America Securities

BAS (United States)
Bank of America Securities LLC
600 Montgomery Street
San Francisco, California 94111
Tel Contact : 415-627-2000

9 West 57th Street
New York, New York 10019
Tel. Contact : 212-583-8000

100 North Tryon Street
Charlotte, North Carolina 28225
Tel. Contact : 888-279-3457
Member NYSE, NASD and SIPC

BAIL (United Kingdom)
Bank of America International Limited
1 Alie Street
London E1 8DE, England
Tel Contact: +44 207 634 4000

BAAL (Hong Kong)
BA Asia Limited
Bank of America Tower
2nd Floor, Hong Kong
Tel Contact: 852-2847-6175

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Familiar Ring

How Effort to Open Local Phone Markets Helped the Baby Bells

An Aggressive SBC Thrives Under New Regulations; A Trend to Oligopolies

Slowing Rollout of Broadband

Six years ago this month, when Congress set out to pry open the nation's local telephone business, Southwestern Bell was the sort of cushy monopoly Washington wanted to bust up.

It controlled virtually all of the local phone lines in a territory spread across five states. It made huge profits. And few competitors dared to cross it.

Today a lot has changed—but not in the way Congress expected. Now known as SBC Communications Inc., the company

By Wall Street Journal staff reporters
Shawn Young, Yochi J. Dreazen and
Rebecca Blumenstein.

dominates local phone service in 13 states and controls a third of the nation's phone lines. Annual profits have more than tripled, to \$7.2 billion. And several of its erstwhile rivals are in bankruptcy, leaving many government officials across its region fuming.

"We had a vision that we would have major players competing for our business, that there would be at least two choices for all of us," says Michigan Gov. John Engler. "That has not happened, and that is a great frustration to me."

Retorts Edward E. Whitacre Jr., SBC's combative chief executive: "Our markets are unequivocally open."

The San Antonio company's rise is part of a dramatic consolidation of power in the nation's \$112 billion-a-year local telephone market. Far from losing out to their competitors, the four remaining Baby Bells—SBC, Verizon Communications Inc., BellSouth Corp. and Qwest Communications International Inc.—now form one of the most powerful blocs in the business world. With control of more than 90% of the nation's local phone lines, they're on the verge of storming the long-distance market as well. One measure of their market heft: Average local phone bills have jumped 17% since the Telecommunications Reform Act of 1996 went into effect, according to the advocacy group Consumers Union.

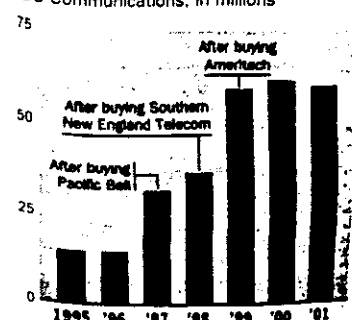
At a time when economic forces are leading industry after industry to gravitate toward a few major players, the troubles of telecom reform aren't unique. America's skies are dominated by six big carriers despite more than two decades of airline deregulation. Tearing down government restrictions on interstate banking has left that industry overshadowed by a few megabanks. And the once-diffuse cable business is now an oligopoly: If Comcast Corp.'s planned merger with AT&T Broadband goes through, three companies will control 65% of the U.S. market.

Still, few regulatory overhauls have flamed out more visibly—or cost investors more—than the one that sought to bring some competition to America's dial tone. Scores of companies that were formed in recent years to take on the Bells have stumbled badly, and dozens are in bankruptcy proceedings or have shut down.

Many policymakers now concede that it may be impossible to foster meaningful competition from within the local phone industry. Michael Powell, chairman of the Fed-

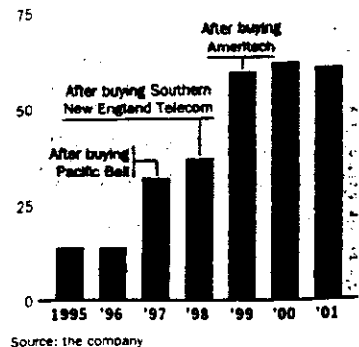
Ringin' Up Sales

Number of local telephone lines served by SBC Communications, in millions



Ringin' Up Sales

Number of local telephone lines served by SBC Communications, in millions



eral Communications Commission, argues that competition will come from without, as the powerful players that control the cable and wireless phone industries accelerate efforts to offer voice and data services.

"Many people make the mistake of assuming that big is somehow bad," says Mr. Powell. "But of course there will be big companies, and when you look at the investment that telecom requires, there should be."

The 111-page telecom reform bill, signed into law in February 1996 after two years of negotiation, was patterned in many ways after the successful deregulation of long-distance in the 1980s. Back then, AT&T Corp. was stripped of its Bell monopolies by court edict and forced to rent its long-distance network to rivals, such as MCI Communications Corp., while the upstarts assembled their own nationwide networks.

For the Bells, the Federal Communications Commission decided to implement the new law by using a carrot and a stick. If they proved they had opened their local phone networks to competitors, the Bells would get permission to enter long-distance within their home territories. And if

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Competition Sputters in the Local Telephone Market

Continued From First Page
they didn't, an intricate network of fines was established, to be assessed by federal and state regulators.

One thing lawmakers and investors didn't adequately contemplate, however, was how hard it would be for competitors to replicate the Bells' main asset: control over the "last mile" of wires into America's homes and businesses. The other thing: how fiercely the Bells would fight to defend that asset.

None of the regional Bell giants has been as aggressive as SBC, which began to attack the FCC almost immediately after the agency began unweaving rules and regulations designed to put the act into place. The company blasted the agency for moves such as requiring it to allow competitors to lease access to its network and equipment.

Relations really deteriorated in the summer of 1997, when the FCC rejected SBC's application to sell long-distance service in Oklahoma. The FCC said that the application was woefully lacking, noting, for instance, that SBC cited as evidence of local competition four residential customers served by tiny Brooks Fiber Properties Inc.—even though all four were employees of that company using the service on an experimental basis. The rejection infuriated SBC officials.

"The FCC is playing games with us," complained Mr. Whitacre a few days after the decision. The 60-year-old engineer, who got his start in the phone business climbing poles during summer breaks in college, believed the agency was being far too strict.

SBC then went to court, arguing that the act was unconstitutional because it im-

posed special restrictions on Bells trying to sell long-distance that didn't apply to their smaller competitors, and that regulators had overstepped their authority. The company hired noted constitutional lawyer Lawrence Tribe and filed its sweeping, complex lawsuit in federal court in tiny Wichita Falls, Texas. SBC won an initial round but lost on appeal.

The early clashes with the FCC and the prospect of losing customers to competitors cemented Mr. Whitacre's desire to get bigger. Phone lines were the company's business, says Mr. Whitacre, "and we were best off to enlarge that business."

In April 1996, three months after the act was passed, Southwestern Bell announced its \$17 billion deal to buy Pacific Bell, which serves the huge California market. Then, in May of 1998, Mr. Whitacre reached for the big prize—the \$62 billion acquisition of Ameritech, the former Bell that serves the five-state Midwest region.

An Immediate Pledge

Recognizing potential regulatory opposition to its growing might, SBC officials immediately pledged that the combined company would be a torchbearer for local competition by attacking 30 large markets in the heart of other Bells' territories. "Between these 30 new markets and the regions it currently serves, SBC will offer service nationwide to 180 million people—two-thirds of the U.S. population," the company vowed when it closed the deal in 1999.

But as it was promising a grand entrance across the nation, the company helped regulators craft lax standards for keeping that promise.

Under these standards, in each market SBC promises to serve outside its own turf, the company is required to serve as few as three homes. It has to install or lease only one piece of switching equipment in each market in the first three years after the merger. The company eventually must install additional switching equipment in the markets, but it isn't required to seek more customers.

"Our game plan is to meet the merger commitments to the letter of the law," says Mike Gilliam, the SBC vice president in charge of meeting regulatory standards for getting into long-distance. So far, the expan-

sion hasn't gotten very far. SBC closed an office in Atlanta last year only two weeks after opening it with 40 employees. Similar retrenchments occurred in Tampa and Seattle.

For many regulators, the Ameritech merger was a turning point in the effort to inject competition into local phone service. "One of the biggest concerns was that Ameritech, the most progressive and innovative of the Bells, was going to be absorbed by SBC, which had a well-earned reputation for doing everything they could to slow down competition," says Bob Atkinson, who headed the FCC's common-carrier bureau during the merger.

Soon after the Ameritech merger, consumer advocates and local officials say, service quality in the Midwest plummeted as large numbers of employees left. Customers were forced to endure long waits for new phone lines or repairs in record numbers. Adding to the aggravation were sales tactics that officials in several states have complained were aggressive and misleading. Customers trying to take care of routine matters like getting copies of bills couldn't get service until they'd listened to sales pitches that sometimes involved misleading labels like "the basics" for expensive packages of add-on services.

"They keep you on the phone for 45 minutes before you can even get a real person," says Arthur J. Zaccanti, a resident of Clinton Township, Mich. "Who is watching out for the consumer here?"

Around the country, SBC has racked up \$188 million in penalties since 1999 for failing to meet competition and service requirements. Last month, the FCC proposed slapping SBC with a \$6 million fine, one of its largest penalties ever, for failing to meet standards for opening its former Ameritech markets in the Midwest to competitors.

SBC officials are exasperated by the fines, which they say are blown far out of proportion at a time when they are meeting standards more than 90% of the time. Company officials say they gauge performance according to 100,000 measures every month, and even minor gaffes can trigger automatic penalties. "It's impossible not to pay money," says general counsel Jim Ellis. "And every time you do, you get a headline. It's an absurd system."

For example, the company says it paid nearly \$50,000 in a three-month period last year for taking between 1.07 seconds and 1.35 seconds to send certain electronic responses to competitors in Indiana and Wisconsin over its electronic systems. The standard SBC failed to meet is response within one second. The company wants the standard changed to two seconds.

Perception Problem

"Obviously we had our problems in the Ameritech region," says William M. Daley, the former commerce secretary in the Clinton administration, who is now SBC's president. "And now there's a knee-jerk perception that there are problems, when the data don't back it up." SBC says service in the Midwest is now back to where it was before it went into a tailspin, and in some areas it's better than it has been in more than a decade.

All told, the company says, competitors are serving 12 million lines in its territory and it has devoted 6,000 of its 193,000 employees to meeting their needs. Competitors continue to gain market share, although at a rate half that of a year ago, according to analysts. SBC cites as evidence of its good faith the fact that regulators have granted it permission to provide long-distance service in five states.

But competitors who connect to the old Ameritech system complain that continued bungling by SBC is hurting them because their customers naturally blame them when something goes wrong. Competitors also complain that wholesale prices for leasing parts of Bell networks are often arbitrary and intentionally anticompetitive.

In Ohio, SBC charged competitors an administrative fee of \$111.86 per line every time they signed up a customer or moved an existing customer onto a different internal billing framework that's better for the competitors. In Michigan, regulators let Ameritech charge only 34 cents for making the same switch. It took Ohio regulators nearly a year to knock the fee down to 74 cents.

SBC knew its \$111.86 fee would never stick and that it would have to refund the difference between its rate and the one the state set, contends Jerry Finefrock, founder of LDMI Telecommunications, a company based in Hamtramck, Mich., that provides long-distance, Internet and local phone service. "They did that deliberately as a barrier to entry," he says.

CoreComm, a rival carrier based in New

York City, says in an antitrust suit it filed against SBC in an Ohio federal court that the Bell giant owes it \$3.6 million in reimbursement for the overcharge. Its suit says when CoreComm switched customers from one form of wholesale ordering to another at SBC, a behind-the-scenes process that shouldn't have affected service, many customers lost their phone service entirely, had calls misdirected or got services they never ordered, which CoreComm was billed for.

SBC says the suit is a misguided attempt to turn a billing dispute into an antitrust matter.

Both CoreComm and Mr. Finefrock complain that SBC continues to cling to arbitrary policies that push up their costs and make competing for local customers maddening and expensive. The company's internal systems for handling orders remain woefully inadequate, say rivals who claim that the difficulties slow them down and force them to intervene manually in matters that should be handled with a few keystrokes on a computer.

"They are a very, very aggressive company. There's no doubt about that," says Terry Harvill, head of the Illinois Commerce Commission, which narrowly approved the Ameritech merger in 1999. Last year, Illinois regulators got into a confrontation with Mr. Whitacre after trying to force SBC to share its data lines with competitors. Mr. Whitacre sent an angry letter threatening to slow the company's rollout of speedy Internet access if regulators didn't ease off. SBC later made good on the threat.

"Saying they'll withhold DSL from that many people is really concrete evidence that you're dealing with a textbook monopolist," says Mr. Harvill.

SBC says it can't put huge investments at risk when regulators keep changing the rules and often force it to offer rivals facilities and services below cost.

As SBC has postponed its broadband rollout to 100 cities, Gov. Engler is worried that businesses in Michigan are losing a competitive edge. Whirlpool Inc. of Benton Harbor, Mich., for example, has to conduct trials of its Internet-controlled appliances for the future in Kansas City, Kan., where there is widespread broadband access available to consumers' homes.

Mr. Whitacre makes no apologies for the DSL slowdown and gives every sign he's willing to escalate his battle with regulators. "Somebody needs to stand up and say what they believe," he says.



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PacBell starts price war to secure piece of DSL market

Karen Rodriguez Business Journal Staff Writer

Pacific Bell Internet Services is sparking a price war in broadband Internet services in an aggressive campaign to garner a large DSL customer base.

The San Francisco-based phone company, owned by SBC Communications Inc., has cut the price on its basic digital subscriber line Internet service to \$39.95 a month, from \$49.95 a month, and is waiving the \$200 startup fees.

Driving prices down is fierce competition--predominately in metro areas from DSL and cable modem providers to offer high-speed Internet and voice services over existing telephone lines.

"The trend following SBC's announcement is for the price of basic DSL transport services to fall considerably over the course of this year," said Brett Sheppard, lead DSL analyst with TeleChoice Inc., a telecommunications consultancy in Denver.

At the heart of the price war is the challenge SBC, PacBell and other local phone companies are seeing from upstart

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DSL competitors, including Covad Communications Inc. in Santa Clara, Northpoint Communications Inc. in San Francisco and Minnesota-based Rhythms NetConnections Inc.

These publicly held companies have spent the past year building out their high-speed DSL networks and serving mainly business customers. This year, they are all aggressively targeting consumers with their range of DSL services, and plan by the third quarter to begin offering low-cost voice services over DSL, potentially drawing customers away from PacBell, Mr. Sheppard said.

"Voice-over-DSL is the greater threat to SBC and PacBell," he said.

TeleChoice anticipates the competitors of PacBell and other incumbent phone companies will be out in front in their voice-over-DSL services.

To reach more customers, PacBell recently extended its DSL service offering to an additional 200,000 homes and businesses in California.

PacBell's promotion is part of a \$6 billion SBC initiative called Project Pronto, announced last November, to serve 12 million homes and businesses nationwide with DSL data and voice services by 2002.

SBC claims it holds the largest DSL market with 169,000 lines sold as of Dec. 31. The phone company does not break out subscriber numbers by region. By comparison, Covad has sold 57,000 lines, according to Dec. 31 quarterly earnings reports.

PacBell's DSL services are available to 6.2 million homes and businesses throughout California and 2 million customers in the San Francisco Bay Area, said Shawn Dainas, spokesperson for PacBell.

Starting in March, PacBell Internet Services will kick off an extensive advertising campaign, targeting consumers in one ad and businesses in another, Mr. Dainas said.

"This is yet another move to make DSL available to the

• Enterprise



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mass market," he said.

Roadblocks to making DSL widely available have been the distance limitations inherent in DSL technology and the installation delays caused by a shortage of qualified technicians.

PacBell says it has found a way to overcome both problems.

By installing more fiber lines in neighborhoods and adding neighborhood gateways, the company has been able to extend its services beyond the former limitation of service within a 3.3-mile radius of one of PacBell's equipment offices. It says it can now guarantee DSL speeds of 1.5 megabytes per second to customers at the edge of the service boundaries.

And self-install services, made available with new filters for the phone jack, will eliminate the typical seven- to 10-day delay before a serviceman manually installs the equipment.

Once the connections are completed, PacBell later this year may offer additional services such as faster download of MP3 files, filtering services, and secure, high-speed data connections at a cost significantly lower than existing services.

"SBC will earn money by packaging additional value-added services so the highway to the Internet becomes essentially free," said TeleChoice's Mr. Sheppard.



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